

GLOBAL ECONOMY » The globalisation of the world economy means the global yield curve is more important than national ones

# Yield curve perspectives

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## main points

- » Historically, an inverted curve, when short rates are higher than long rates, is a harbinger to a recession
- » In the current environment, it is more common for local yield curves to invert when excess global demand for long term bonds causes long rates to remain low
- » The UK yield curve has flattened dramatically in the past few years, primarily due to the most recent tightening cycle by the Bank of England that began in the autumn of 2003
- » Normally when the spread between the long and short ends of the global yield curve reaches an extreme, it has been a good predictor of the direction equities are likely to head



ANDREW TEUFEL

The yield curve is a representation of a series of interest rates from short to long duration at a given point in time. This simple yet powerful metric reflects the ease and availability of capital and is generally accepted as an accurate predictor of the future course of economies. Historically, an inverted curve, when short rates are higher than long rates, is a harbinger to a recession. However, the globalisation of the financial markets has made the individual local market curves less predictive than the overall shape of a 'global' yield curve.

Simply put, financial institutions borrow money at short-term interest rates and lend at long-term rates. Typically, long-term yields are higher than short-term yields – generating profit for lending institutions and creating an incentive to lend. An accommodating monetary environment provides opportunity for corporations to leverage their balance sheets and increase investments and earnings.

However, if this yield curve spread becomes negative, when short rates are higher than long rates, incentives are diminished and lending standards generally become more restrictive. The resulting constrictive monetary environment is a headwind to future economic growth.

### Excess global demand

In the current environment, it is more common for local yield curves to invert when excess global demand for long-term bonds causes long rates to remain low. However, the advancement of global banks, financial instruments for hedging and widely available market information allows capi-

tal to flow significantly easier across borders than in past periods. Banks can now access short rates in more favourable foreign markets quite easily making local yield curves less relevant. The 'global' yield curve, a synthetic construct based on international gross domestic product-weighted interest rates, is a more complete measure of the availability of global funding sources.

When looking at yield curves, it is important to understand the differences between the markets for short-term and long-term interest rates. Short rates are controlled by a country's central bank – determined by a selected committee in response to monetary policy. Central banks generally increase short-term rates to combat inflationary environments and decrease to stimulate growth.

### Market forces

Long-term rates are essentially set by market forces. As inflation expectations decrease due to rising short-term rates, long rates fall as the resulting demand for long-term debt in the open markets increases. When demand increases for these long-term bonds, prices increase and yields fall. While short rates may move up or down independent of long rates, depending on country specific central bank policies, long rates generally trend together based on global market forces.

The UK yield curve has flattened dramatically in the past few years, primarily due to the most recent tightening cycle by the Bank of England that began in the autumn of 2003. The central bank raised rates from a low of 3.5 per cent to a high of 4.75 per cent in less than 12 months, only easing back to 4.5 per cent (where the rates remain) in mid 2005. With the UK economy continuing to grow and expectations for long rates remaining unchanged, the curve may remain inverted.

Historically, when long rates were lower than short rates, bond investors expected an economic slowdown and a subsequent reduction in short rates by the central bank. However, current economic expectations are increasing for the UK economy, as exemplified by Gordon Brown's recent forecast of accelerated growth, as well as increasing analyst estimates.

### Inflation

During the same period of central bank tightening, long-term rates have fallen from around 5 per cent to around 4 per cent as inflation expectations remain contained (February core CPI was up a mere 1.4 per cent year on year). Substantial demand for long-term debt by emerging markets and oil producing regions flush with cash has kept long bond yields low.

Additionally, recent changes to UK pension regulations are causing fund managers to reduce

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risk and increase fixed interest holdings. This excess marginal demand contributes to the shortage of available long-term debt.

The UK yield curve inverted in the autumn of 2004 and has remained inverted ever since. The most recent inversion is nothing more than a supply/demand imbalance at the long end of the curve.

Exceptional demand for long-dated assets and low inflationary expectations have pushed yields to low levels by historical standards. And equity market performance during this period has been substantially above average.

### Credit

As financial institutions increasingly operate in global credit markets, they are no longer bound by the borrowing and lending rates of their domicile alone. This makes the notion of a 'global' yield curve a more useful leading indicator for equities and the global economy than any single market curve. Although the UK yield curve is inverted, the global curve retains a positive slope.

Historically, when the spread between the long and short ends of the global yield curve reaches an extreme, it has been a good predictor of the direction equities are likely to head. When the spread is positive and high, equities tend to do very well. When the spread is below zero, poor equity returns usually follow.

The current spread is not extreme and is within the range that typified much of the late 1990s. The curve has flattened in the past two years, but remains sufficiently steep to suggest the economic expansion and equity bull market can continue.

### Think globally

The inverted UK yield curve is a prime example of why assessing the state of any single country's yield curve no longer carries the same predictive power it once offered. The inversion had little effect on economic performance, as the UK was the only major developed market to avoid falling into a recession during the most recent global downturn.

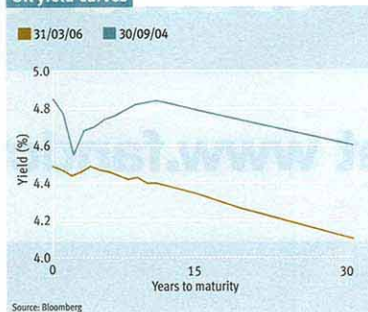
In years past, it was sufficient to examine an individual country's yield curve to understand more about the direction of equities. However, as the flow of capital becomes an increasingly global phenomenon, companies frequently borrow in countries that can offer more attractive rates. As a result, single country yield curves portend less about economic and equity environments than they once did. So while the UK yield curve is inverted, you can remain bullish on global equities, in part because the global yield curve spread remains positive.

Andrew Teufel is research director of Fisher Investments



Globalisation: individual countries' yields curves are now less relevant

### UK yield curves



### Global yield curve

